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No. 06-1509

IN THE SUPREME COURT OF THE UNITED STATES

MICHAEL H. BOULWARE,
Petitioner,

v.

UNITED STATES OF AMERICA,
Respondent.

On Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

BRIEF FOR PETITIONER

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QUESTION PRESENTED

Whether the diversion of corporate funds to a shareholder of a corporation without earnings and profits automatically qualifies as a non-taxable return of capital up to the shareholder's stock basis, *see* 26 U.S.C. § 301(c)(2), even if the diversion was not intended as a return of capital.

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BRIEF FOR PETITIONER

OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1-14) is reported at 470 F.3d 931.[1] The court of appeals' order denying Boulware's petition for rehearing (Pet. App. 63) is unreported. The district court's oral rulings (JA 50-56, 90-92, 137-38) are unreported. The court of appeals' ruling on Boulware's first appeal (Pet. App. 27-62) is reported at 384 F.3d 794.

JURISDICTION

The court of appeals entered judgment on December 13, 2006. Pet. App. 1. The court denied a timely petition for rehearing on April 23, 2007. Pet. App. 63. Petitioner invoked the jurisdiction of this Court under 28 U.S.C. § 1254(1) by filing a petition for writ of certiorari on May 11, 2007. This Court granted the petition on September 25, 2007.

STATUTORY PROVISIONS INVOLVED

Section 301 of the Internal Revenue Code (Title 26, United States Code) provides in relevant part:

> (a) In general. Except as otherwise provided in this chapter, a distribution

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[1] The Appendix to the petition for a writ of certiorari is cited as "Pet. App." The Joint Appendix is cited as "JA." The Excerpts of Record from the court of appeals are cited as "ER."

of property (as defined in section 317(a)) made by a corporation to a shareholder with respect to its stock shall be treated in the manner provided in subsection (c).

. . . .

(c) Amount taxable. In the case of a distribution to which subsection (a) applies--

(1) Amount constituting dividend. That portion of the distribution which is a dividend (as defined in section 316) shall be included in gross income.

(2) Amount applied against basis. That portion of the distribution which is not a dividend shall be applied against and reduce the adjusted basis of the stock.

(3) Amount in excess of basis.

(A) In general. . . . [T]hat portion of the distribution which is not a dividend, to the extent that it exceeds the adjusted basis of the stock, shall be treated as gain from the sale or exchange of property.

. . . .

Section 316 of the Internal Revenue Code provides in relevant part:

> (a) General rule. For purposes of this subtitle, the term "dividend" means any distribution of property made by a corporation to its shareholders--
>
> (1) out of its earnings and profits accumulated after February 28, 1913, or
>
> (2) out of its earnings and profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.
>
> Except as otherwise provided in this subtitle, every distribution is made out of earnings and profits to the extent thereof, and from the most recently accumulated earnings and profits. To the extent that any distribution is, under any provision of this subchapter, treated as a distribution of property to which section 301 applies, such distribution shall be treated as a distribution of property for purposes of this subsection.

STATEMENT OF THE CASE

Petitioner Michael Boulware founded Hawaiian Isles Enterprises ("HIE") in the 1980s and served as chairman and president of the company. HIE and its subsidiaries sell coffee, bottled water, and other products, primarily in Hawaii. At all relevant times, Boulware owned at least half of the HIE stock. JA 68, 74, 82-83, 86-88, 133.

In 2001, the government obtained an indictment against Boulware, charging him with tax evasion and tax perjury. *See* IRC §§ 7201, 7206(1).[2] The tax counts alleged that Boulware failed to report as income approximately $10 million that he allegedly diverted from HIE. JA 10-18.

The government contended that Boulware diverted the money from HIE in several ways. First, it asserted that between 1989 and 1993, HIE sold coffee to two companies--Pele Trading and Hawaiian Kona Coffee--and that Boulware directed those companies to make payments totaling $2.6 million to him or to his girlfriend, Jin Sook Lee. *E.g.*, ER 307-12, 333-41, 460-61, 1010. Second, the government claimed that over a three-year period, Boulware obtained $3.6 million that HIE received from direct sales of tobacco and coffee products at its warehouse. ER 463-67. Third, the government alleged that in 1992, Boulware converted for his own use $638,000

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[2] All citations to the Internal Revenue Code ("IRC") are to Title 26 of the United States Code. The original indictment also charged Boulware with making false statements to a federally insured financial institution and conspiracy to make false statements. Those charges are not at issue here.

loaned to HIE by a financial institution. ER 343-66. Fourth, the government contended that Boulware caused HIE to pay for work on the house where Jin Sook Lee lived. ER 396-401. Fifth, the government asserted that in 1994 Boulware obtained $295,000 from HIE through Bonded Construction and a company Boulware owned named Automated Equipment. ER 315-23, 404-09, 1010. Sixth, from 1993 through 1995, Automated Equipment received $1.2 million from HIE for what the government claimed were phony lease arrangements. ER 467-69, 1010. Finally, the government alleged that from 1995 through 1997, Boulware obtained a substantial amount of money from HIE through two Hong Kong companies--Harvest International Coffee King and Forest Trading--and a Tonga company. *E.g.*, ER 327-30, 375-93, 412-17, 472-79, 1010. *See generally* ER 495-520 (summarizing transactions).

Following a guilty verdict, a panel of the Ninth Circuit reversed Boulware's conviction. The court held that the district court erred in excluding evidence of a state court judgment in an action brought by Jin Sook Lee against Boulware and HIE concerning ownership of funds transferred to her. *United States v. Boulware*, 384 F.3d 794 (9th Cir. 2004) (reprinted at Pet. App. 33-52), *cert. denied*, 546 U.S. 814 (2005).

At the retrial, Boulware sought to negate the "tax deficiency" and false statement elements of the tax evasion and tax perjury charges by presenting evidence that the money he received from HIE constituted nontaxable returns of capital he had

invested in the company. JA 58-66, 97-98. He also sought a return of capital jury instruction. JA 26-30.

The government moved to exclude the return of capital evidence. JA 19. Citing *United States v. Miller*, 545 F.2d 1204 (9th Cir. 1976), the government argued that before the return of capital rules apply in a criminal tax case, "'there must be some demonstration on the part of the taxpayer and/or the corporation that such distributions were intended to be [a return of capital].' . . . Where, however, no such foundation is laid, the constructive distribution rules are irrelevant to the issues in criminal tax prosecutions and do not apply." JA 21-22 (quoting *Miller*, 545 F.2d at 1215). The government also opposed Boulware's proposed return of capital jury instruction. It again noted the requirement under *Miller* that Boulware establish a contemporaneous intent to treat the diverted funds as a return of capital. JA 36, 39-40. The government explained "[t]he rational[e] behind such a rule" as follows: "Tax evaders should not escape criminal liability simply because the intricacies of the tax law result in no tax due and owing." JA 40.

The district court agreed with the government. Relying on *Miller*, the court concluded that, to obtain admission of the return of capital evidence, Boulware "must not show merely that the funds could have been a return of capital; he must introduce evidence showing that, at the time of the transfer, the funds were in fact a return of capital." JA 138; *see* JA 91 ("Thus, if the constructive dividend rules are to apply, the defendant must make the requisite showing that the distributions

were intended to be a return of capital."). Because Boulware could not make this showing, the court precluded his evidence and refused to give a return of capital jury instruction. *E.g.*, JA 50-56, 90-92, 137-38.

The jury found Boulware guilty. The district court sentenced him to 60 months incarceration. JA 178. He appealed. JA 188.

On December 13, 2006, the court of appeals affirmed Boulware's conviction and sentence. Because Boulware's proffered evidence in support of his return of capital defense did not satisfy the *Miller* contemporaneous intent requirement, the court concluded that the district court did not err in excluding that evidence and in refusing to instruct on the defense. Pet. App. 3-6. The court recognized that under *Miller* the return of capital rule applies differently in criminal cases than in civil cases. It also acknowledged that its approach conflicts with decisions from the Second Circuit. Pet. App. 5-6. Concurring, Judge Thomas observed that if the panel were "writing on a clean slate, rather than under the controlling precedent of [*Miller*], I would adopt the approach of the Second Circuit concerning the return to capital defense." Pet. App. 13.

The court of appeals denied Boulware's petition for rehearing en banc on April 23, 2007. Pet. App. 63. This Court granted Boulware's timely petition for writ of certiorari on September 25, 2007.

SUMMARY OF ARGUMENT

The return of capital rule arises from the interplay of IRC §§ 301 and 316. Section 316(a) defines "dividend" as "any distribution of property made by a corporation to its shareholders . . . out of its earnings and profits . . . ." Section 301(c)(1) provides that dividends are taxed as ordinary income. Section 301(c)(2) provides that distributions that do not constitute dividends shall be applied against and reduce the shareholder's basis in his stock. Such returns of the shareholder's investment in his stock are not income and thus are nontaxable. Finally, IRC § 301(c)(3) provides that nondividend distributions that exceed the shareholder's basis are taxed as capital gains.

The Ninth Circuit has added an additional hurdle for criminal defendants seeking to invoke the return of capital rule in IRC § 301(c)(2). The defendant must not only produce evidence that the corporation lacked earnings and profits and the distribution did not exceed his basis in the stock; he must *also* provide a "demonstration on the part of the taxpayer and/or the corporation that such distributions were intended to be such a return [of capital]." *Miller*, 545 F.2d at 1215; *see* Pet. App. 4.

The *Miller* contemporaneous intent requirement has no basis in the statutory text and creates an unwarranted disparity between civil and criminal tax liability. *Miller* also improperly reduces the government's burden of proof on the tax deficiency element of tax evasion under IRC § 7201. *See, e.g., United States v. Bok*, 156 F.3d 157 (2d Cir. 1998);

United States v. D'Agostino, 145 F.3d 69 (2d Cir. 1998).

The government offers two defenses of the result in this case. First, it contends that the phrase "with respect to its stock" in IRC § 301(a) supports the *Miller* contemporaneous intent requirement. But that phrase merely differentiates between corporate distributions unrelated to the shareholder's status as such--salary and loans, for example--and all other distributions to shareholders, including constructive dividends and returns of capital. The phrase does not require that the shareholder or the corporation manifest any particular intent before a distribution is considered to be "with respect to [the corporation's] stock" and thus subject to IRC § 301(c).

Second, the government argues that *unlawful* corporate distributions to a shareholder are excluded from the provisions of IRC §§ 301 and 316 and thus must be taxed as ordinary income regardless of the corporation's earnings and profits. The language of §§ 301 and 316 provides no support for such an exception to the ordinary rules governing corporate distributions. Although an unlawful distribution to a shareholder may have civil and criminal consequences to the corporation and the shareholder, the unlawfulness does not change the taxation of the distribution.

Even if the Court determines that the unlawful character of a distribution removes it from the provisions of IRC §§ 301 and 316, that does not affect the result here. No jury (or court, for that

matter) has found that the diversions from HIE to Boulware violated any law. An appellate finding of unlawfulness would violate Boulware's Fifth and Sixth Amendment right to have a jury decide all facts essential to a verdict of guilt beyond a reasonable doubt. Thus, if the Court determines that unlawful distributions do not fall within IRC §§ 301 and 316, it should reverse Boulware's conviction and remand for a new trial. At a retrial of this case, the government would have an opportunity to prove to a jury beyond a reasonable doubt that the distributions from HIE to Boulware were unlawful.

ARGUMENT

I. SECTIONS 301 AND 316 OF THE INTERNAL REVENUE CODE GOVERN THE TAXATION OF CORPORATE DIVERSIONS.

Two statutes--IRC §§ 301 and 316--govern the taxation of money that a taxpayer diverts from a corporation in which he owns stock. IRC § 301(c)(1) provides that "dividends" are taxed as ordinary income.[3] IRC § 316(a) defines "dividend" as "any distribution of property made by a corporation to its shareholders . . . out of its earnings and profits . . . ." IRC § 316 adds that, with exceptions not applicable here, "every distribution is made out of earnings and profits to the extent thereof, and from the most

[3] IRC § 301(c) applies "in the case of a distribution to which subsection (a) applies." IRC § 301(a), in turn, applies to distributions "made by a corporation to a shareholder with respect to its stock." We discuss the phrase "with respect to its stock" in Part II(B) below.

recently accumulated earnings and profits." IRC § 301(c)(2) provides that "[t]hat portion of the distribution which is not a dividend"--that is, the portion of the distribution that is not "out of earnings and profits"--shall be "applied against and reduce the adjusted basis of the stock." Such returns of the shareholder's investment in his stock are not income and thus are nontaxable. Under IRC § 301(c)(3), nondividend distributions that exceed the shareholder's basis are taxed as capital gains.

In combination, these statutes produce the return of capital rule at issue in this case: When a corporation without earnings or profits distributes funds to a shareholder, the distribution is a nontaxable return of capital, up to the shareholder's basis in his stock. Courts have repeatedly applied this principle to a taxpayer's diversion of money from a corporation in which he owns stock.

The return of capital rule applies to shareholder diversions of corporate funds even where the corporation does not formally label the distribution as a dividend. Courts characterize such diversions as "constructive dividends" and apply the taxation principles in IRC §§ 301(c) and 316. *See, e.g., United States v. Bok*, 156 F.3d 157, 162 (2d Cir. 1998); *United States v. D'Agostino*, 145 F.3d 69, 72-73 (2d Cir. 1998); *Noble v. Commissioner*, 368 F.2d 439, 442-43 (9th Cir. 1966); *DiZenzo v. United States*, 348 F.2d 122, 125-27 (2d Cir. 1965).

Since the watershed decision in *Truesdell v. Commissioner*, 89 T.C. 1280 (1987), the United States Tax Court has consistently applied IRC

§§ 301(c) and 316 to shareholder diversions. *See, e.g., AJF Transportation Consultants v. Commissioner*, 77 T.C.M. (CCH) 1244 (1999); *DiLeo v. Commissioner*, 96 T.C. 858, 883-85 (1991).[4] *Truesdell* reasoned that

> [a]s a general proposition, where a taxpayer has dominion and control over diverted funds, they are includable in his gross income under section 61(a) . . . unless some other modifying Code section applies. The latter is the situation here, since Congress has provided that funds (or other property) distributed by a corporation to its shareholders over which the shareholders have dominion and control are to be taxed under the provisions of section 301(c).

89 T.C. at 1298; *see DiZenzo*, 348 F.2d at 125.

Following *Truesdell*, the IRS accepted the application of IRC § 301(c) to diverted funds. The Tax Litigation Division of the IRS recommended acquiescence in the decision. It declared:

> Funds diverted to the shareholder of a wholly owned corporation should be regarded as constructive distributions, unless the funds were additional salary

[4] For a history of the changing positions taken by the Tax Court and the IRS before *Truesdell* concerning the taxation of corporate diversions, see Stephen D. Gardner, *The Tax Consequences of Shareholder Diversions in Close Corporations*, 21 Tax. L. Rev. 223 (1966).

> or otherwise were received in a nonshareholder capacity. The funds should be included in the income of the corporation and taxed to the shareholder in accordance with I.R.C. § 301(c). When such funds are received in a shareholder capacity, we will no longer argue they are ordinary income regardless of earnings and profits.

Truesdell, 89 T.C. 1280, *action on dec.*, AOD 1988-025 (Sept. 12, 1988), *reprinted at* 1988 AOD LEXIS 22; *see id., acq.*, 1988-2 C.B. 1 n.10, *reprinted at* 1988 IRB LEXIS 3924.

The "constructive dividend" approach follows from the definition of "dividend" in IRC § 316(a). That definition--"any distribution of property made by a corporation to its shareholders . . . out of its earnings and profits"--does not require any corporate formalities. Rather, the definition turns on three factors: the distribution must be (1) by a corporation (2) to a shareholder in his capacity as such (3) out of earnings and profits. As long as those circumstances exist, the distribution is a dividend subject to taxation under IRC § 301(c)(1). If the corporation lacks earnings and profits, then the taxation rules in IRC § 301(c)(2) and (c)(3) apply.

II. THE *MILLER* CONTEMPORANEOUS INTENT REQUIREMENT HAS NO STATUTORY BASIS AND DISREGARDS THE TAX DEFICIENCY ELEMENT OF CRIMINAL TAX EVASION.

Despite the apparent simplicity of IRC §§ 301 and 316, the Ninth Circuit has refused in criminal cases to apply those statutes as written. The court requires a criminal defendant not only to produce evidence that the corporation lacked earnings and profits and that the distribution did not exceed his basis in the stock, but also to show an intent by the corporation or the shareholder, at the time of the distribution, to treat it as a return of capital. The Ninth Circuit bases this contemporaneous intent requirement on a purported distinction between criminal and civil tax cases. As we demonstrate in Part II(A) below, that distinction is baseless, and even the government does not appear to defend it.

The government rests its appellate defense of *Miller* on the phrase "with respect to its stock" in IRC § 301(a). *Miller* itself attaches no significance to that phrase, and for good reason. Part II(B) shows that the language on which the government seizes merely distinguishes between corporate distributions to shareholders in some other capacity--salary paid to a shareholder employee, for example, or a debt repayment to a shareholder creditor--and distributions to shareholders in their capacity as such. The phrase "with respect to its stock" thus provides no basis for the *Miller* contemporaneous intent requirement.

A. Section 301 Applies in Criminal Tax Cases As It Does in Civil Tax Cases.

Contrary to *Miller* and the courts below, and consistent with *Bok* and *D'Agostino*, the substantive tax principles in IRC §§ 301 and 316 apply in criminal tax cases just as they do in civil tax cases. The Ninth Circuit erred in *Miller* and in this case in requiring that criminal defendants establish, as a condition to raising the return of capital defense, that the corporation or the taxpayer intended the distribution as a return of capital at the time it was made. This contemporaneous intent requirement has no basis in the statutory text and creates an unwarranted disparity between civil and criminal tax liability.

Criminal tax cases often require the government to prove that the defendant had income that he failed to report. In a prosecution for tax evasion under IRC § 7201, the government must prove the existence of a tax deficiency. *See, e.g., Sansone v. United States*, 380 U.S. 343, 351 (1965); Pet. App. 3. Similarly, in a prosecution under IRC § 7206(1) for subscribing a tax return that understates the taxpayer's income, the government must prove that the income figure on the return is false--that is, that the taxpayer had more income than he reported.

When (as here) the purported income at issue consists of money the defendant diverted from a corporation in which he owns stock, the defendant may invoke IRC §§ 301 and 316. In particular, the defendant may contend--as Boulware sought to do--that the corporation lacked earnings and profits,

that the diversion did not exceed the defendant's basis in his stock, and thus that the diverted funds constitute a nontaxable return of capital under IRC § 301(c)(2), rather than a dividend or other form of income that must be included in gross income under IRC § 61(a). By showing that the diverted money is not income, the defendant seeks to negate the tax deficiency element of IRC § 7201 and the false statement element of IRC § 7206(1).

In response to return of capital claims, some courts have declared that the rules in IRC § 301(c) apply differently in criminal tax cases than they do in civil cases. Apart from *Miller* and the court of appeals' decision here, however, these cases can be read to address the allocation of the burden of proof on the return of capital issue, rather than the applicable substantive principles.[5] The courts hold that the government satisfies its prima facie burden on the tax deficiency element by establishing that the defendant received and controlled the diverted funds. The defendant then has the burden of producing evidence that the corporation lacked earnings and profits and that the distribution at issue did not

[5] *See, e.g., United States v. Peters*, 153 F.3d 445, 460 (7th Cir. 1998) (noting that the majority of courts addressing a return of capital defense in criminal cases "have held that the government need not prove the character of the diverted funds"); *United States v. Williams*, 875 F.2d 846, 849-52 (11th Cir. 1989) (rejecting the defendant's contention that the government had not met its burden of proof on the tax deficiency element because it had failed to prove the existence of earnings and profits); *Davis v. United States*, 226 F.2d 331, 335-36 (6th Cir. 1955) ("While, of course, the burden of proof does not shift in a criminal case, it is the rule that when the government establishes a prima facie case, it is then for the defendant to overcome the inferences reasonably to be drawn from the proven facts.").

exceed the stock basis. In finding the evidence sufficient on the tax counts in Boulware's first appeal, the Ninth Circuit appeared to read *Miller* in this way. Pet. App. 54.

At Boulware's second trial, neither the government nor the district court disputed that Boulware's proffered evidence would meet his burden of production on the earnings and profits and basis aspects of IRC § 301(c). The district court (later affirmed by the court of appeals) held instead that Boulware had failed to produce evidence of an intent by the corporation or the taxpayer, *at the time of the distribution*, to treat it as a return of capital. Pet. App. 5-6 (court of appeals); JA 50-56, 90-92, 137-38 (district court).

This contemporaneous intent requirement began with *Miller*. That case involved the prosecution of a defendant who had diverted money from his closely held corporation to his own benefit. Following a bench trial, the district court found that the funds at issue were salary and thus constituted gross income under IRC § 61. *See* 545 F.2d at 1212. Although it would have been sufficient for affirmance simply to hold that the trial court's finding was not clearly erroneous--a conclusion for which the record provided ample support, *see id.* at 1215-16--the court of appeals elected to discuss the defendant's contention that the diverted funds had to be treated as a return of capital. That discussion as well could have been brief; the defendant failed to meet his burden of producing evidence that the corporation had no earnings and profits, *see id.* at 1213 n.11, and Miller's own expert testified that the

diverted funds exceeded his basis in the stock by $68,800, *see id.* at 1210 n.7.

Rather than limit itself to these points, however, the Ninth Circuit elected to analyze the application of IRC §§ 301 and 316 in criminal tax cases. The court framed the issue as follows: "This court must decide whether the rules of constructive distribution are to be automatically applied in the present situation, a review of a *criminal* tax proceeding." *Miller*, 545 F.2d at 1214. The court identified what it considered a decisive difference between civil and criminal tax cases: "In civil tax cases the purpose is tax collection and the key issue is the establishment of the amount of tax owed by the taxpayer. In a criminal tax proceeding the concern is not over the type or the specific amount of the tax which the defendant has evaded, but whether he has willfully attempted to evade the payment or assessment of a tax." *Id.* The court elaborated on this point:

> The difficulty in *automatically* applying the constructive distribution rules to this case is that it completely ignores one essential element of the crime charged: the willful intent to evade taxes, and concentrates solely on the issue of the nature of the funds diverted. That latter aspect is not the important element. Where the taxpayer has sought to conceal income by filing a false return, he has violated the tax evasion statutes. It does not matter that that amount could have somehow

> been made non-taxable if the taxpayer had proceeded on a different course. To apply the constructive distribution rules to this situation would nullify all of the taxpayer's prior unlawful acts.

Id. In a footnote, the court added: "At the time the funds are initially diverted, it might well be argued that they could constitute either income or a return of capital. However, once the taxpayer has assumed control of the funds and then fails to report such funds as income or to make any adjustments in the corporate books to reflect a return of capital, he has already violated the tax evasion statutes." *Id.* at 1214 n.12.[6]

Miller noted what it described as an "anomalous situation" that would arise "[i]f constructive distribution rules were automatically applied." *Id.* at 1214. According to the court, "[a] taxpayer who diverted funds from his close corporation when it was in the midst of financial difficulty and had no earnings and profits would be immune from punishment (to the extent of his basis in the stock) for failure to report such sums as income; while that very same taxpayer would be convicted if the corporation had experienced a successful year and had earnings and profits." *Id.*

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[6] In support of this proposition, *Miller* cited *Spies v. United States*, 317 U.S. 492, 498-99 (1943). But nothing in *Spies* supports the *Miller* reasoning. In *Spies* the petitioner "admitted . . . that he had sufficient income during the year in question to place him under a statutory duty to file a return and to pay a tax, and that he failed to do either." *Id.* at 493. Thus, there was no issue in *Spies* concerning the tax deficiency element of tax evasion.

Having rejected "automatic" application of the return of capital rule in criminal tax cases, the Ninth Circuit turned to the circumstances under which it would permit a criminal defendant to raise the rule in defense of a tax evasion charge. The key, in the *Miller* court's view, is the contemporaneous intent of the shareholder and the corporation. The court declared that "[t]o constitute [a return of capital], there must be some demonstration on the part of the taxpayer and/or the corporation that such distributions were intended to be such a return." *Id.* at 1215. The court made clear that the taxpayer or the corporation must intend a return of capital *at the time of the distribution.* In outlining its reasons for affirming the district court's decision, the court observed that "Miller presented no concrete proof that the amounts were considered, intended, or recorded on the corporate records as a return of capital *at the time they were made.*" *Id.* (emphasis added).

The return of capital analysis in *Miller* and the courts below is wrong for three principal reasons. First, the *Miller* approach "effectively eliminates proof of a tax deficiency as an element of a 26 U.S.C. § 7201 violation." *D'Agostino*, 145 F.3d at 73. In the words of one scholar, *Miller* "completely ignored the fact that one of the three elements in an evasion case is the existence of a tax due and owing." Linda S. Eads, *From Capone To Boesky: Tax Evasion, Insider Trading, and Problems of Proof*, 79 Cal. L. Rev. 1421, 1454 (1991).[7] The "anomaly" *Miller* noted between a

[7] The government stated this position starkly in its objection to Boulware's proposed return of capital instruction. It declared that "[t]ax evaders should not escape criminal liability simply

defendant whose corporation had earnings and profits and one whose corporation did not is no anomaly at all; it is the difference between a defendant who violated the tax evasion statute and one who did not. In the words of *D'Agostino*, "The diversion of the funds cannot constitute a criminal offense, despite criminal intent, if no taxes are due." 145 F.3d at 73. By reading the tax deficiency element out of IRC § 7201, *Miller* reduces the prosecution's burden of proof and thus violates the defendant's right to due process.

Second, as Judge Thomas recognized in his concurrence below, the *Miller* contemporaneous intent requirement produces an unwarranted anomaly: corporate distributions that do not count as income for civil tax purposes under the return of capital rule *do* count as income for purposes of the tax evasion and tax perjury statutes. Pet. App. 13-14; *see, e.g., D'Agostino*, 145 F.3d at 73. Thus, under the Ninth Circuit's approach, a shareholder who has no income under IRC § 301(c) and *Truesdell* and who therefore has no tax liability could nevertheless be found to have a tax deficiency under IRC § 7201 and to have falsely reported his (nonexistent) income under IRC § 7206(1).

In other words, in the civil setting, a corporate distribution to a shareholder in his capacity as such

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because the intricacies of tax law result in no tax due and owing." JA 40. What the government and the Ninth Circuit overlook is that the existence of a "tax due and owing" *is an element of the offense of tax evasion.*

is a nontaxable return of capital, regardless of the intent of the taxpayer and the corporation at the time of the distribution, as long as the corporation has no earnings or profits and the distribution does not exceed the taxpayer's basis in his stock. But according to the Ninth Circuit, that same distribution constitutes income for purposes of a criminal prosecution unless the taxpayer can show that, at the time of the distribution, he and the corporation intended a return of capital. The contemporaneous intent requirement thus "result[s] in a logical fallacy, [and] is in flat contradiction with the tax evasion statute's requirement of 'the existence of a tax deficiency.'" Pet. App. 13-14 (Thomas, J., concurring).[8]

The substantive rules under which a court determines whether tax is owed should not vary depending on whether the case is criminal or civil. The government conceded in its opposition to the petition for certiorari that IRC § 301 "applies equally

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[8] The Ninth Circuit's analysis in *Noble v. Commissioner*, 368 F.2d 439 (9th Cir. 1966), highlights that court's disparate treatment of civil and criminal tax cases. In *Noble*, a civil case, the government argued that payments by a corporation to shareholders were taxable constructive dividends, rather than nontaxable loan repayments as the shareholders contended. The parties stipulated that neither the corporation nor the shareholders intended the payments to constitute dividends. *See id.* at 443. The court of appeals declared that "[the] intention of the parties is not controlling" and that "[t]o constitute a distribution taxable as a dividend, the benefit received by the shareholder need not be considered as a dividend either by the corporation or its shareholders . . . ." *Id.* (quotation omitted). Thus, *Miller* treats the contemporaneous intent of the corporation and the shareholder as decisive in a criminal tax case, while *Noble* disregards that intent in a civil tax case.

to civil and criminal tax proceedings." Brief for the United States in Opposition at 15. As three Members of this Court remarked in terms equally applicable here, "It is true that the Government brought a criminal evasion prosecution rather than a civil deficiency proceeding against petitioner, but this can in no way alter the substantive tax law rules which alone are determinative of liability in either case." *James v. United States*, 366 U.S. 213, 253 (1961) (Whittaker, Black, and Douglas, JJ., concurring in part and dissenting in part); *cf. Nordstrom v. United States*, 360 F.2d 734, 735 (8th Cir. 1966) ("To be criminally liable on this charge [tax evasion], it first must appear that appellant was under a civil liability to pay the tax.").

By engrafting the contemporaneous intent requirement on IRC §§ 301 and 316 in *Miller*, the Ninth Circuit created an impermissible and illogical dichotomy between civil and criminal cases. If anything, tax statutes in a criminal setting should be interpreted, to the extent they reasonably can be, in the defendant's favor. *Cf. United States v. Thompson/Center Arms Co.*, 504 U.S. 505, 518 (1992) (plurality opinion) (applying rule of lenity to potentially criminal tax statute applied in civil setting); *White v. Aronson*, 302 U.S. 16, 20 (1937) ("Where there is a reasonable doubt as to the meaning of a taxing Act it should be construed most favorably to the taxpayer."). *Miller* erroneously reverses that interpretive principle.

Third, the *Miller* contemporaneous intent requirement lacks any basis in the statutory text. The language of IRC §§ 301 and 316 gives no hint

that the return of capital rule requires an intent by the taxpayer or the corporation, at the time of the distribution, to treat it as a return of capital.

In fact, IRC § 316 by its terms establishes that the shareholder and the corporation often do not know at the time of the distribution whether it is a taxable dividend or a nontaxable return of capital. IRC § 316(a)(2) defines "dividend" as "any distribution of property made by a corporation to its shareholders . . . out of its earnings and profits of the taxable year (*computed as of the close of the taxable year* without diminution by reason of any distributions made during the taxable year), *without regard to the amount of the earnings and profits at the time the distribution was made*." (Emphasis added.)

As the emphasized language shows, earnings and profits for purposes of § 316(a)(2) cannot be determined until the "close of the taxable year," which may be months after the distribution occurs. Moreover, the earnings and profits determination must be made "without regard to the amount of the earnings and profits at the time the distribution was made." IRC § 316(a)(2). "This means that a distribution will be a 'dividend' if the corporation has earnings and profits at the end of the current taxable year, even though it had none when the distribution occurred; conversely, a distribution that seemed to be a 'dividend' when made may turn out to be a return of capital because the corporation has no earnings and profits at the end of the year or for prior years." 1 Boris I. Bittker & James S. Eustice, *Federal Income Taxation of Corporations and*

Shareholders ¶ 8.02[2], at 8-12 (7th ed. 2006). Because the shareholder and the corporation may not know until long after the distribution whether it is a dividend or a return of capital, it makes no sense--and is contrary to the statutory scheme--to require a contemporaneous intent that the distribution be a return of capital.

The approach of the Second Circuit in *D'Agostino* and *Bok* squares with the language of IRC §§ 301 and 316 and suffers none of the infirmities of the *Miller* contemporaneous intent approach. *D'Agostino* and *Bok* recognize that a tax deficiency is an element of the offense of tax evasion under IRC § 7201; that the same substantive rules for determining income apply in criminal and civil tax cases; and that, under IRC §§ 301 and 316, the tax status of corporate funds diverted to a shareholder in his capacity as such depends exclusively on whether the corporation had earnings and profits and the extent of the shareholder's basis in his stock.

D'Agostino and *Bok* make clear that, for IRC § 301(c)(2) to apply, the shareholder and the corporation need not have intended the diverted funds to be a return of capital at the time of the diversion. As *Bok* explained,

> [I]n return of capital cases, a taxpayer's intent is not determinative in defining the taxpayer's conduct. That is, the taxpayer or the corporation need not have described the distribution at issue as a dividend or a return of capital at the time it was made; rather, the

> realities of the transaction--including the amount of the shareholder's basis and the corporation's earnings or profits, as well as the amount of the distribution--govern its characterization for tax purposes.

156 F.3d at 162; *see D'Agostino*, 145 F.3d at 72-73. Because *Bok* and *D'Agostino* hew faithfully to the statutory text, the Court should adopt their interpretation of IRC §§ 301 and 316.

B. The Phrase "With Respect To Its Stock" in Section 301(a) Does Not Support the Court of Appeals' Decision.

The government argued in its opposition to certiorari that the phrase "with respect to its stock" in IRC § 301(a) supports the *Miller* approach to the return of capital rule. Brief for the United States in Opposition at 12-13. This contention is implausible on its face. Although *Miller* alludes to that phrase in passing, *see* 545 F.2d at 1210 n.5, the Ninth Circuit never cites it as a basis for the contemporaneous intent requirement. The court of appeals in this case did not even mention the language that the government now claims is decisive. Pet. App. 3-6.

This silence is not surprising. The phrase "with respect to its stock" serves merely to distinguish money that a taxpayer receives from a corporation in his capacity as a shareholder from money that he receives in some other capacity--as an employee, for example, or as a creditor. *See* 26

C.F.R. § 1.301-1(c) ("Section 301 is not applicable to an amount paid by a corporation to a shareholder unless the amount is paid to the shareholder in his capacity as such."); S. Rep. 1622, 83d Cong., 2d Sess. 231 (1954) ("Subsection (a) accordingly makes clear that section 301 has applicability only to distributions of property to shareholders in their capacity as such. For example, a distribution of property to a shareholder who is a creditor of the corporation in satisfaction of his claim against the corporation is not within the scope of section 301."). As Professors Bittker and Eustice explain, "Even though such transfers are 'distributions,' in the sense of being transfers, they are not made to a shareholder 'with respect to [his] stock,' as required by § 301(a), because the corporation receives equal value . . . ; hence, the tax consequences of such transfers are governed by other sections of the Code." 1 Bittker & Eustice, *supra*, ¶ 8.05[1], at 8-39 (footnote omitted).

Apart from *Miller* and its progeny in the criminal context, courts do not define constructive dividends (or other distributions "with respect to [a corporation's] stock") in terms of the intent of the corporation or the shareholder. Rather, a constructive dividend exists "if the corporation confers a direct benefit on [the shareholder] from available earnings and profits without expectation of repayment." *Neonatology Associates, P.A. v. Commissioner*, 299 F.3d 221, 231-32 (3d Cir. 2002). As the Tax Court has recognized, "Where a corporation confers an economic benefit on a shareholder without the expectation of repayment, that benefit becomes a constructive dividend, taxable to the shareholder,

even though neither the corporation nor the shareholder intended a dividend." *Magnon v. Commissioner*, 73 T.C. 980, 993-94 (1980) (emphasis added); *see, e.g., Dynamics Corp. of America v. United States*, 392 F.2d 241, 247 (Ct. Cl. 1968) ("It is not the intent of the parties that governs the characterization of the distribution, but rather the economic and consequent legal effect of their actions.").

The government correctly notes that the intent of the shareholder and the corporation may be significant in determining whether a payment constitutes salary, a loan repayment, or some other form of distribution in a nonshareholder capacity. Brief for the United States in Opposition at 12-15. From this sound premise, however, the government makes an unwarranted leap. It concludes that intent is *also* important in establishing that a distribution is "with respect to [a corporation's] stock." That is wrong.

If a party to a tax controversy contends that a distribution to a shareholder should *not* be treated as subject to IRC § 301(c)--if a party contends, for example, that the distribution should be treated as salary, or a loan repayment, or a loan--then that party may well have the burden of producing evidence of a corresponding intent. *See, e.g., Crowley v. Commissioner*, 962 F.2d 1077, 1079 (1st Cir. 1992) ("A shareholder distribution is a loan, rather than a constructive dividend, if at the time of its disbursement the parties intended that it be repaid."); *Elliotts, Inc. v. Commissioner*, 716 F.2d 1241, 1244-45 (9th Cir. 1983) (requiring evidence of

"compensatory intent" where distribution was alleged to be compensation); *King's Court Mobile Home Park, Inc. v. Commissioner*, 98 T.C. 511, 514 (1992) (same). But where there is no evidence of such intent (or no evidence of intent at all), courts (other than *Miller* and its progeny) treat a corporate distribution to a shareholder under the taxation rules of IRC § 301(c). To express this point in terms of IRC § 301(a), courts infer that a corporate distribution to a shareholder is "with respect to its stock" and thus subject to IRC § 301(c) unless there is evidence to the contrary.

In this case, neither party contended in the district court that the $10 million HIE distributed to Boulware constituted salary or some other form of compensation.[9] No evidence was presented of "compensatory intent." And, although Boulware contended in the alternative that some of the distributions were repayments of loans he had made to HIE, the government disputed this characterization. The government never contended in the district court that the HIE distributions at issue were other than "with respect to its stock." The government's

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[9] It is not surprising that neither party took this position. From Boulware's perspective, salary or other compensation constitutes gross income under IRC § 61(a). From the IRS' perspective, characterizing the diverted funds as compensation to Boulware would ensure taxability at his level but would allow HIE a deduction under IRC § 162(a). Characterizing the diverted funds as constructive dividends, by contrast, denies HIE a compensation deduction and also permits taxation of Boulware to the extent HIE had earnings and profits or the distribution exceeded Boulware's basis in his stock. *See, e.g., Neonatology Associates*, 299 F.3d at 231-32 (IRS argues successfully that distributions to shareholders are constructive dividends rather than compensation and thus nondeductible by the corporation); *King's Court Mobile Home Park, Inc.*, 98 T.C. at 514-15 (same).

sole (and successful) contention was that Boulware could not establish a contemporaneous intent to treat the distributions as a return of capital, as *Miller* requires, and thus that he could not assert the return of capital defense. That was the district court's sole basis for precluding the defense and the court of appeals' sole basis for affirmance. Because the *Miller* contemporaneous intent requirement has no textual basis and improperly distinguishes between criminal and civil tax cases, the Court should reject it in favor of the better-reasoned *Bok* and *D'Agostino* approach.

III. SECTION 301 APPLIES TO UNLAWFUL DIVERSIONS.

The government argues in the alternative that the taxation principles in IRC § 301(c) do not apply to "unlawful" shareholder diversions of corporate assets. In the district court, however, "the government did not allege or prove that [Boulware's] diversions of corporate funds were unlawful." *D'Agostino*, 145 F.3d at 73 (refusing to apply "unlawfulness" exception to return of capital rule absent such proof). Nor did the government contest the lawfulness of the HIE diversions to Boulware before the Ninth Circuit panel. Judge Thomas raised that issue for the first time in his concurrence. Pet. App. 14.[10] Seizing on Judge

[10] Judge Thomas asserted that "[b]ecause Boulware claimed that the diversions were made to defraud his ex-wife from her share of property in the diverce proceedings, these diversions may properly be considered unlawful." Pet. App. 14 (citing *Boulware*, 384 F.3d at 801). But the language Judge Thomas cited from *Boulware* does not support a finding that Boulware obtained the money from HIE to defraud his ex-wife, or even that he "claimed" to have done so. The district court made no

Thomas' suggestion, the government argued in its oppositions to rehearing en banc and certiorari that Boulware's diversions were unlawful and thus could not be considered returns of capital. In particular, the government suggested that Boulware had breached his fiduciary duty to the trust he established for his son, which held fifty percent of the HIE stock, and that he had diverted the funds to defraud his wife in their divorce. *See* Brief for the United States in Opposition at 16-17.[11]

The Court should reject the proposed "unlawfulness" exception to the normal operation of IRC §§ 301 and 316. Nothing in the language of those statutes supports different tax treatment of lawful and unlawful shareholder diversions. The characterization of a diversion for tax purposes turns solely on the factors that the statutes identify--the amount of earnings and profits, the shareholder's basis in the stock, and the size of the distribution. In the absence of statutory language distinguishing lawful transactions from unlawful transactions, they must be treated the same for tax purposes.

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finding that the distributions from HIE to Boulware were for that purpose. In any event, the issue, to the extent it is material, must be decided by a jury.

[11] The government also contended that Boulware's conspiracy conviction in his first trial established that he "diverted corporate funds in furtherance of a conspiracy to make false statements to a federally insured institution." Brief for the United States in Opposition at 17. But Boulware's conspiracy conviction establishes only that he conspired to obtain funds unlawfully *from a federally insured financial institution.* It does not establish that Boulware unlawfully diverted funds *from HIE.*

James illustrates this point. In that case, the Court rejected a taxpayer's contention that embezzled funds did not constitute "gross income" under IRC § 61. Although the opinions in *James* (none of which commanded a majority) reached varying conclusions, none disputed that the core question was whether embezzled funds should be included in the statutory term "gross income." *See, e.g., James*, 366 U.S. at 213 (plurality opinion); *id.* at 222-23 (Black & Douglas, JJ., dissenting); *id.* at 241 (Clark, J., concurring in part and dissenting in part). No Justice suggested that the language of IRC § 61 could be disregarded or expanded because the funds at issue had been unlawfully obtained.

Some cases have suggested in dictum that the return of capital principles in IRC §§ 301(c)(2) and 316 "would not necessarily apply in a case of unlawful diversion, such as embezzlement, theft, a violation of corporate law, or an attempt to defraud third party creditors." *D'Agostino*, 145 F.3d at 73; *see, e.g., Bok*, 156 F.3d at 162 n.1 (same); *Truesdell*, 89 T.C. at 1298 ("In this case petitioner's diversions of income . . . were not per se unlawful. The diverted funds were not, at least on their face, stolen, embezzled or diverted in fraud of creditors. There has been no suggestion that the diversions were improper as a matter of corporate law."); *DiZenzo*, 348 F.2d at 125 (same). But these cases provide no textual analysis or other support for any such "unlawfulness" exception to the taxation principles in IRC §§ 301(c) and 316. No case since *Truesdell* squarely holds that such an exception exists.

It is possible to imagine circumstances in which a shareholder's unlawful appropriation of corporate funds would not fall within the language of IRC §§ 301 and 316. If a General Motors shareholder broke into corporate headquarters and stole money from petty cash, for example, that would not be a constructive dividend, because the theft would not constitute a "distribution" by the corporation to the shareholder "with respect to its stock." Instead, the stolen funds would be directly includable in gross income under IRC § 61(a) as construed in *James*. Such an appropriation would be excluded from IRC §§ 301 and 316 not because it is unlawful, but because it does not fall within the statutory language. But when a shareholder with control over a corporation diverts corporate funds to himself, whether lawfully or unlawfully, the taxation rules of IRC §§ 301 and 316 control.

The decision in *Drybrough v. Commissioner*, 238 F.2d 735 (6th Cir. 1956), illustrates this point. In *Drybrough*, the holders of 80 percent of the stock of a close corporation diverted corporate funds to themselves. The wife of one of the shareholders--who held 20 percent of the stock--did not know about the diverted funds. The court of appeals found that, despite the possible fraud upon the unwitting shareholder, the taxation rules in the predecessors to IRC §§ 301 and 316 controlled. The court noted that the shareholders "were not employees who embezzled from an unwitting employer, but officers, directors and stockholders in complete domination and control of their corporation." 238 F.2d at 738. It added that "even though received by petitioners under a claim of right, the funds are taxable as

dividends only to the extent that the corporation had earnings and profits for the years in which they were withdrawn." *Id.* The court concluded that "[t]o the extent of earnings and profits thus determined the diverted funds will be taxed to petitioners as ordinary income in the years received. Withdrawals in excess of earnings and profits will be taxed as capital gains after the adjusted basis of petitioners' stock has been exhausted." *Id.* at 740. *Drybrough* reflects a straightforward application of the IRC § 301(c) taxation rules to an unlawful diversion.

Even if the Court determines that some forms of unlawful diversion do not fall within the terms of IRC §§ 301 and 316 (such as the shareholder theft from General Motors described above), that provides no basis for affirming Boulware's conviction. Boulware (like every other criminal defendant) has a Fifth and Sixth Amendment right to a jury determination beyond a reasonable doubt on every fact essential to a finding of guilt. *See, e.g., United States v. Booker*, 543 U.S. 220, 230 (2005); *United States v. Gaudin*, 515 U.S. 506, 509-15 (1995); *In re Winship*, 397 U.S. 358, 364 (1970). A tax deficiency is an essential element of the tax evasion charges, and a false statement--alleged here to be an understatement of income--is an essential element of the tax perjury charges. To the extent the government seeks to overcome Boulware's return of capital defense on those elements by showing that his diversion of HIE funds was unlawful, it must prove the unlawful conduct to a jury beyond a reasonable doubt.

The government has never been put to its proof on unlawfulness, before a jury or otherwise. Thus, if the Court concludes that some or all unlawful diversions do not fall within IRC §§ 301 and 316, the proper course is not to engage in appellate factfinding, but to reverse and remand for a new trial at which both parties can present evidence to a jury on the unlawfulness issue. *See, e.g., Sullivan v. Louisiana*, 508 U.S. 275, 280 (1993).

CONCLUSION

The judgment of the court of appeals should be reversed.

Respectfully submitted,

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